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COORDINATED ISSUE
UTILITY INDUSTRY
UNITED KINGDOM WINDFALL TAX
UIL 901.12-00

Issue:

Whether the United Kingdom (the “U.K.”) Windfall Tax enacted on July 2, 1997, and imposed on certain British utilities, is a creditable income tax within the meaning of Internal Revenue Code (the “Code”) sections 901(a) and 902(a), or under Article 23(1) of the Convention Between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland (1980) (the “Convention”).

Facts:

Commencing in the 1980's, the U.K. Parliament enacted a series of statutory provisions that "privatized" certain government-owned public utilities through the selling of their shares to the public. A number of these privatized entities (U.K. regional electric companies) were acquired by U.S. utility companies.

On July 2, 1997, the U.K. enacted the U.K. Windfall Tax, a one-time windfall tax on the "excess profits" of certain privatized utilities. This tax was equal to 23 percent of the difference between the “value of the company in profit making terms” and the company’s "flotation value," and was payable in two equal installments, one due on or before December 1, 1997, and one due on or before December 1, 1998.

For purposes of the windfall tax, the “value of a company in profit making terms” was defined as 9 times the company's average annual after-tax profits, as reported for U.K. tax purposes, for the four years immediately following flotation (but no later than April 1, 1997) (the "initial period"). The "flotation value" of a company was defined as the price paid for the company's stock by the public at the time the company was privatized.

The windfall tax was a tax imposed on the privatized utility company in addition to the generally imposed U.K. corporate income tax but was not deductible in computing the company’s corporate income tax liability and could not be offset by the advance corporation tax.

As discussed below, a U.S. corporation generally is treated as having paid a proportionate share of the income taxes paid by a foreign corporation in which it owns 10 percent or more of the voting stock when it receives a dividend from that corporation.

Because several U.S. utility companies invested in the regional electricity companies, they were indirectly affected by the windfall tax. Consequently, they may attempt to recover the windfall tax paid by the U.K. regional utilities by claiming a foreign tax credit, for U.S. income tax purposes, when they receive dividends from the U.K. utility companies.

Law and Analysis:

Creditability Under the Code

A U.S. corporation is entitled to a credit against its U.S. income tax liability for any "income, war profits, and excess profits taxes"[1] (referred to in the regulations collectively as "income taxes") paid or accrued by the U.S. corporation during the taxable year to any foreign country and any such taxes deemed to be paid by the U.S. corporation to a foreign country.[2] Code section 901(a) and (b)(1); Treas. Reg. § 1.901-2(a)(1). Under section 902, a U.S. corporation that owns 10 percent or more of the voting stock of a foreign corporation is deemed to have paid a portion of the income taxes paid by the foreign corporation when it receives a dividend from such corporation. Code section 902(a) and (c)(4). The portion deemed paid is the amount of income taxes that bears the same ratio to the foreign corporation's post-1986 income taxes as the amount of the dividend bears to the foreign corporation's post-1986 undistributed earnings. Code section 902(a).

For a levy paid to a foreign country to qualify for a credit under section 901, it must meet two requirements. First, the levy must be a tax. Treas. Reg. § 1.901-2(a)(1)(i). A "levy is a tax if it requires a compulsory payment pursuant to the authority of a foreign country to levy taxes." Treas. Reg. § 1.901-2(a)(2)(i). It appears that the windfall tax was imposed pursuant to the authority of the U.K. to levy taxes. Further, it appears based on the facts that the windfall tax is a compulsory payment.[3]

Second, the predominant character of the tax must be that of an income tax in the U.S. sense. Treas. Reg. § 1.901-2(a)(1)(ii). The predominant character of a foreign tax is that of "an income tax in the U.S. sense" if it is likely to reach net gain in the normal circumstances in which it applies, but only to the extent that the liability for the tax is not

[1] The term "income, war profits, and excess profits taxes" includes taxes paid in lieu of a tax on income, war profits, or excess profits otherwise generally imposed by any foreign country or by any possession of the United States. Code section 903. The U.K. Windfall Tax in this case is not an "in lieu of" tax under section 903 because it is in addition to the generally imposed corporate income tax, not in substitution therefor. Treas. Reg. § 1.903-1(a)(2) and (b)(1).

[2] The credit allowed pursuant to section 901(a) is subject to the limitation of section 904.

[3] Some commentators have suggested that the validity of the windfall tax could be challenged under customary and treaty-based international law. The commentators suggest that the windfall tax is "confiscatory" and could be regarded as tantamount to an expropriation or form of nationalization. Power Company International Tax Alert, Deloitte & Touche LLP, July 1997, 97 TNI 134-29. To date, it is unknown whether any party has legally challenged the imposition of this tax by the U.K. There were thoughts that the U.K. Treasury chose a valuation formula that uses published and readily available information in order to avoid any legal challenges.

dependent on the availability of a credit against the income tax liability to another country (not a soak-up tax). Treas. Reg. § 1.901-2(a)(3).[4] A foreign tax is likely to reach net gain in the normal circumstances in which it applies only if it satisfies the realization, gross receipts, and net income requirements of the regulations. Treas. Reg. § 1.901-2(b)(1). If a foreign tax does not satisfy any of the three requirements it will not reach net gain and, therefore, it will not be an income tax under the Code and the regulations.

Realization Requirement

Generally, a foreign tax will satisfy the realization requirement if, judged on the basis of its predominant character, it is imposed:

> (A) Upon or subsequent to the occurrence of events ("realization events") that would result in the realization of income under the income tax provisions of the Internal Revenue Code;
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> (B) Upon the occurrence of an event prior to a realization event (a "prerealization event") provided the consequence of such event is the recapture (in whole or part) of a tax deduction, tax credit or other tax allowance previously accorded to the taxpayer; or
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> (C) Upon the occurrence of a prerealization event, other than one described in (b)(2)(i)(B) of this section, but only if the foreign country does not, upon the occurrence of a later event (other than a distribution or a deemed distribution of the income), impose tax ("second tax") with respect to the income on which tax is imposed by reason of such prerealization event (or, if it does impose a second tax, a credit or other comparable relief is available against the liability for such second tax for tax paid on the occurrence of the prerealization event) and –
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> (*1*) The imposition of the tax upon such prerealization event is based on the difference in the values of property at the beginning and end of a period; or
>
> (*2*) The prerealization event is the physical transfer, processing, or export of readily marketable property (as defined in paragraph (b)(2)(iii) of this section).

Treas. Reg. § 1.901-2(b)(2)(i). In this case, the U.K. windfall tax does not satisfy any of the requirements set forth above.

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[4] Liability for a foreign tax is dependent on the availability of a credit against income tax liability to another country only if, and to the extent that, the foreign tax would not be imposed on the taxpayer but for the availability of such a credit. Treas. Reg. § 1.901-2(c)(1). The U.K. Windfall Tax is not dependent on the availability of a credit against the income tax liability to another country and, therefore, is not a soak-up tax within the meaning of Treas. Reg. §1.901-2(c)(1).

First, the windfall tax is not imposed on a "realization event" as required by Treas. Reg. § 1.901-2(b)(2)(i)(A). As noted, the occurrence of a realization event is determined by applying U.S. tax principles. See Biddle v. Commissioner, 302 U.S. 573 (1938). Generally, for U.S. tax purposes, an accession to wealth is clearly realized when it is sufficiently fixed and definite to be treated as gross income. Consequently, the mere appreciation in the value of assets without disposition of such assets is not a realization event. See Eisner v. Macomber, 252 U.S. 189, 210-212 (1920).

In this case, the U.K. Windfall Tax is imposed on the difference between the value of the utility company in profit making terms and the flotation value. This difference represents the estimated appreciation in a utility company's value over the initial period, rather than an additional direct tax on the utility company's income. If the windfall tax were an additional tax on the utility company's income, the tax would have been imposed on the amount of the average earnings for the initial period, instead of nine times that average less the flotation value. As a result, as calculated, the windfall tax could be imposed on amounts that exceed the actual earnings of the utility company (e.g., where the flotation value was low and the earnings for the initial period were high). Admittedly, the computation of the tax base includes a calculation of the utility company's average earnings, earnings that have been realized in the U.S. sense. The use of earnings in the computation, however, is not a means of determining the utility company's income; it is simply a means of valuing the utility company.

Second, the U.K Windfall Tax is not triggered by prerealization events resulting in the recapture of previously allowed amounts. Therefore, it does not satisfy the test set forth in Treas. Reg. § 1.901-2(b)(2)(i)(B).

Finally, the provisions of the U.K Windfall Tax do not preclude the imposition of a second tax on future realized income and do not allow a credit or other comparable relief against the liability for such second tax. Therefore, the U.K. Windfall Tax does not meet the test set forth in Treas. Reg. § 1.901-2(b)(2)(i)(C).

Gross Receipts Requirement

A foreign tax will satisfy the gross receipts requirement "if, judged on the basis of its predominant character, it is imposed on the basis of (A) Gross receipts; or (B) Gross receipts computed under a method that is likely to produce an amount that is not greater than fair market value." Treas. Reg. § 1.901-2(b)(3). In this case, the U.K. Windfall Tax cannot meet this test, because it does not require a realization event. If there is no realization of income, there are no gross receipts on which to impose the tax.

Net Income Requirement

A foreign tax will meet the net income requirement if, judged on the basis of its predominant character, the base of the tax is computed by reducing gross receipts to permit:

> (A) Recovery of the significant costs and expenses (including significant capital expenditures) attributable, under reasonable principles, to such gross receipts; or
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> (B) Recovery of such significant costs and expenses computed under a method that is likely to produce an amount that approximates, or is greater than, recovery of such significant costs and expenses.

Treas. Reg. § 1.901-2(b)(4). Since the windfall tax does not satisfy the gross receipts requirement, it cannot, by definition, satisfy the net income requirement.

Because the windfall tax does not meet the realization, gross receipts, or net income requirements, it is not an income tax in the U.S. sense.

Creditability Under the Convention

Under Article 23(1) of the Convention Between the Government of the United States of America and the Government of the United Kingdom of Great Britain and Northern Ireland (1980), a credit may be allowed against U.S. tax liability for the U.K. taxes listed in Article 2(2)(b), that is, the U.K. income tax, capital gains tax, corporation tax, and petroleum revenue tax. A credit is also allowed, under Article 2(3), for "any identical or substantially similar taxes which are imposed by a Contracting State after the date of signature of this Convention in addition to, or in place of, the existing taxes."

In general, the purpose of a Taxes Covered Article is to ensure that tax treaties do not become obsolete due to changes in the tax systems of the parties to a treaty. Thus, if identical or substantially similar taxes are imposed in addition to, or in place of, the taxes that were in force and covered at the time a treaty was signed, it is appropriate to give effect to the intent of the Contracting States, and allow the treaty to continue to apply to the basic income tax structures of Contracting States. The U.K. Windfall Tax was enacted in Part I (The Windfall Tax) of the Finance (No. 2) Act 1997 as a separate and one-time tax apart from any other U.K. tax. Accordingly, it is not one of the taxes listed in Article (2)(2)(b). The windfall tax is not imposed on a utility's income but rather on the estimated appreciation in a utility company's value. As such the windfall tax is not a tax described in Article 2(3) as "identical or substantially similar" to a tax covered by Article 2(2)(b). Accordingly, a credit for the U.K. Windfall Tax against U.S. tax liability may not be allowed under Article 23(1) of the Convention.

Conclusion:

A U.S. corporation is entitled to a credit against its U.S. income tax liability for any income taxes paid or incurred during the taxable year to a foreign country. Code section 901. The U.S. corporation is also entitled to a credit for its proportionate share of any income taxes paid by a foreign corporation in which it owns 10 percent or more of the voting stock when it receives a dividend from that foreign corporation. Code section 902.

In both circumstances, however, the tax paid or deemed paid by the U.S. corporation must be an income tax within the U.S. meaning of that term. In order to meet this requirement, the tax must require a compulsory payment pursuant to the authority of a foreign country to levy taxes, and it must reach net gain in the normal circumstances in which it applies (as determined by applying the realization, gross receipts, and net income tests set forth in Treas. Reg. § 1.901-2).

The U.K. Windfall Tax was not an income tax under U.S. tax principles. It was imposed on the appreciation in the value of the privatized company, not on the net income of such company. As a consequence, it failed to satisfy the realization, gross receipts, and net income requirements, requirements used to test whether a tax is an income tax in the U.S. sense. Therefore, the U.K. Windfall Tax is not a creditable income tax under sections 901(a) and 902(a). Accordingly, U.S. utility companies owning interests in U.K. regional electric companies may not claim a foreign tax credit under section 902 for the windfall tax paid by the U.K. company.

Finally, the U.K. Windfall Tax is not creditable under Article 23(1) of the Convention.